

Overview of UCITS V

The UCITS V Directive (“**UCITS V**”) amends the regulatory framework for Undertakings for Collective Investment in Transferable Securities (“**UCITS**”) to address issues relating to the depositary function, manager remuneration and administrative sanctions. UCITS V was published in the Official Journal of the EU on 28 August 2014, and EU member states had until 18 March 2016 to transpose the directive into national law. Ireland was one of the first EU member states to implement UCITS V.

UCITS V focuses on three main areas:

- a new depositary regime which includes a clarification of depositary eligibility, duties, liabilities and depositary-related disclosure requirements and a set of rules under which tasks and responsibilities can be delegated;
- rules governing remuneration policies of both UCITS management companies and self-managed UCITS, that must be applied to key members of the managerial staff; and
- the harmonisation of the minimum administrative sanctions regime across member states.

One of the purposes of UCITS V is to more closely align the UCITS regime with the provisions relating to depositaries, remuneration and sanctions under the Alternative Investment Fund Managers Directive (“**AIFMD**”), although there are some notable differences between the two regimes, which are discussed further below. This briefing note gives an overview of the main provisions of UCITS V.

The New Depositary Regime

The provisions on depositaries deal with: depositary eligibility; duties; delegation; liability; and disclosure.

Depositary Eligibility

Under the previous regime, member states enjoyed a discretion as to the institutions deemed eligible to act as UCITS depositaries, provided that the depositaries were institutions which were subject to prudential regulation and ongoing supervision and which could furnish sufficient financial and professional guarantees. UCITS V alters the rules in relation to eligible depositaries by providing that a UCITS depositary must be: (1) a national central bank; (2) a credit institution; or (3) a legal entity authorised by its national competent authority to carry on depositary activities under the UCITS Directive, subject to the fulfilment of certain capital, prudential and organisational requirements. For Irish depositaries, the third limb would include entities authorised by the Central Bank of Ireland (the “**Central Bank**”) under the *Irish Investment Intermediaries Act 1995*.

Duties of the Depositary

Oversight

Under UCITS V, the oversight duties imposed on depositaries remain substantially the same as those imposed by the previous UCITS Directive and were already captured within the pre-existing Central Bank requirements. These include: verifying that units of the UCITS are sold, issued, repurchased, redeemed and cancelled in compliance with applicable laws and the UCITS’ constitutional documents; ensuring that the value of units is calculated in accordance with applicable laws and the constitutional documents; carrying out the management company’s instructions unless they conflict with applicable laws or the constitutional documents; and verifying that any consideration is remitted within the usual time limits and that UCITS’ income is applied in accordance with applicable laws and constitutional documents.

Safekeeping

With regard to safekeeping, UCITS V distinguishes between financial instruments that are capable of being held in custody by the depositary and all other assets, which are subject to record keeping and ownership verification duties. This is an important distinction in the context of the depositary liability regime introduced as part of UCITS V, which is discussed further below.

Asset Segregation and Reuse of Assets

UCITS V requires that financial instruments held in custody are registered in segregated accounts so that they can be clearly identified as belonging to the UCITS at all times. A depositary (or its delegate) is prohibited from re-using the assets which it holds in custody for its own account. The reuse of assets for the account of the UCITS is subject to conditions, including that the reuse be for the benefit of the UCITS and in the interests of unitholders and that the transaction is covered by high quality, liquid collateral received by the UCITS under a title transfer arrangement, the market quality of which at all times amounts to at least the market value of the reused assets plus a premium.

This prohibits the type of re-hypothecation seen in AIFMD structures but facilitates UCITS that wish to engage in initiatives such as securities lending.

Cash Monitoring

The depositary must ensure that cash flows are properly monitored, that is, that all payments made by or on behalf of the investors when subscribing for units in the UCITS have been received, and that all cash of the UCITS has been booked in cash accounts that are opened in the name of the UCITS or other specified entity and maintained appropriately.

Delegation of Depositary Safekeeping Duties

UCITS V aligns the requirements relating to the delegation of safekeeping duties with those set out in the AIFMD. Only the safekeeping function may be delegated, subject to specified conditions including that the tasks are not delegated with the intention of circumventing the UCITS regime, the depositary must be able to demonstrate an objective reason for the delegation, and the depositary must exercise all due skill, care and diligence in the selection, appointment, periodic review and ongoing monitoring of its delegate.

In addition, the depositary must ensure that the delegate sub-custodian meets a range of specific conditions. The delegate must have structures and expertise that are adequate and proportionate to the nature and complexity of the assets of the UCITS entrusted to it. Where custody tasks are delegated, the delegate must be subject to effective prudential regulation and supervision and to external periodic audit to ensure that the financial instruments are in its possession. The delegate must segregate the assets of the depositary's clients from its own assets and from the assets of the depositary, so that they can be clearly identified as belonging to the clients of a particular depositary. The delegate must comply with the same requirements applicable to the depositary regarding the reuse of assets held in custody.

It should be noted that where local law requires that certain financial instruments be held in custody by a local entity and no local entities satisfy the delegation requirements, the depositary may nonetheless appoint a local entity provided certain disclosure requirements are satisfied and the UCITS or its management company has expressly instructed the depositary to delegate to such a local entity.

Depositary Liability

Under the formerly applicable provisions, a depositary was liable for its: (i) unjustifiable failure to perform its obligations; or (ii) improper performance of them. UCITS V provides for a new strict liability regime in the context of a loss of financial instruments held in custody. In the event of such loss by a depositary (or its delegate) an obligation is imposed on the depositary to replace the financial instrument or pay the value to the UCITS without undue delay. A depositary can only avoid this strict liability standard where it can prove, cumulatively, that the loss was as a result of an external event, beyond its reasonable control, the consequences of which would have been unavoidable despite all reasonable efforts to the contrary.

In contrast to the AIFMD, it is not possible under UCITS V for a depositary to contractually discharge liability in the case of the loss of financial instruments by its delegate, meaning that the loss must be borne by the depositary rather than by the delegate.

Apart from the case of the loss of financial instruments, the depositary will also be liable to the UCITS and the investors of a UCITS if a loss is suffered as a result of the depositary's negligence or intentional failure to properly fulfil its obligations under the UCITS Directive. All UCITS investors may invoke the liability of the depositary directly or indirectly through the management company, irrespective of the legal structure of the fund. The wording of UCITS V differs to the previously applicable provisions (and the AIFMD) which stated that the right to invoke claims depends on the legal nature of the relationship between the depositary, the management company and the investors. It remains to be seen how the courts will interpret the amended provisions.

Disclosure

The disclosure obligations relating to the depositary have been amended by UCITS V to provide that the prospectus must contain:

- the identity of the depositary and a description of its duties and of conflicts of interest that may arise;
- a description of any safekeeping functions delegated by the depositary, the list of delegates and sub-delegates and any conflicts of interest that may arise from such delegation; and
- a statement that up-to-date information regarding the two above points will be made available to investors on request.

Prior to the introduction of UCITS V, the Central Bank already required the prospectus to disclose the material provisions of the contract between the management company and depositary as well as a brief description of the duties being performed and the relevant termination provisions.

Remuneration Provisions

Consistent with the approach adopted under the AIFMD, UCITS V requires UCITS managers and self-managed UCITS to implement remuneration policies and practices ("RPPs") that:

- are consistent with and promote sound and effective risk management of the UCITS;
- discourage disproportionate risk-taking which is inconsistent with the risk profiles or fund rules governing the relevant UCITS;
- are in line with the business strategy, objectives, values and interests of the management company and the UCITS it manages or the investors; and
- include measures to avoid conflicts of interest.

Application and Scope

The RPPs are to apply to any staff member whose professional activities have a material impact on the risk profiles of the management companies or of the UCITS they manage. The categories of staff affected are likely to include not only senior management and investment decision-makers, but also certain persons who are paid commensurate salaries.

One of the more controversial issues in the debate preceding the adoption of UCITS V related to the application of the remuneration provisions to delegates. This issue is not dealt with in the substantive provisions of UCITS V, however, according to its recitals, the remuneration policies and practices should also apply in a proportionate manner "*to any third party which takes investment decisions that affect the risk profile of the UCITS because of functions delegated to it...*".

In October 2016, the European Securities and Markets Authority ("ESMA") published the finalised *Guidelines on sound remuneration policies under the UCITS Directive* (the "**UCITS Remuneration Guidelines**"). The UCITS Remuneration Guidelines apply from 1 January 2017. The UCITS Remuneration Guidelines follow the approach under the AIFMD remuneration requirements and provide that, where a UCITS manager has delegated activities to service providers, such service providers should be subject to "*equivalent regulatory requirements on remuneration that are equally as effective as [the UCITS remuneration guidelines]*" or appropriate contractual arrangements should be put in place to ensure that there is no circumvention of the UCITS remuneration requirements. Where this approach may lead to an individual being subject to several regulatory regimes eg, AIFMD, CRD IV and UCITS V, compliance with one regulatory regime will be sufficient for the purposes of the other regimes' requirements.

The RPPs must respect a number of principles specified in UCITS V, which address governance, pay structure and risk alignment. While the general obligation to have sound RPPs applies to all management companies, regardless of their size or systemic importance, the remuneration principles are themselves subject to the principle of proportionality. This means that management companies need only comply with those principles in a way and to the extent that is appropriate to their size, internal organisation and the nature, scope and complexity of their activities.

UCITS managers will need to assess which members of staff and which employment contracts are impacted by these remuneration requirements and should put in place a compliant remuneration structure. As noted above, the UCITS Remuneration Guidelines apply from 1 January 2017. The UCITS Remuneration Guidelines state that the guidance on the rules on variable remuneration should apply for the calculation of payments relating to new awards of variable remuneration for identified staff for the first full performance period after 1 January 2017.

Governance

UCITS V requires the management company's non-executive board members to: adopt the remuneration policy; adopt and review at least annually the general principles of the remuneration policy; and take responsibility for and oversee their implementation. The remuneration policy's implementation must be subject, at least annually, to a central and independent internal review for compliance with the remuneration policies and procedures adopted by the management company.

UCITS V requires "significant" management companies to establish a remuneration committee. Whether or not a management company is sufficiently significant is to be evaluated in terms of: (1) its size or the size of the UCITS it manages; (2) its internal organisation; and (3) the nature, scope and complexity of its activities. The UCITS Remuneration Guidelines provide that, in assessing whether a management company is significant, a management company should consider the cumulative presence of all three of these factors. A management company which is significant only with respect to one or two of the three factors should not be required to set up a remuneration committee. The UCITS Remuneration Guidelines suggest that the setting up of a remuneration committee should be considered, as a matter of good practice, even by those management companies that are not obliged to set up such a committee. The remuneration committee is responsible for preparing decisions regarding remuneration, including those which have implications for the risk and risk management of the management company or the UCITS concerned and which are to be taken by the management body in its supervisory function.

Pay Structure and Risk Alignment

Several of the UCITS V remuneration principles seek to ensure that remuneration is effectively aligned with risk. In particular, UCITS V stipulates that RPPs should be designed to discourage risk taking inconsistent with the risk profiles, rules or instruments of incorporation of the UCITS.

UCITS V sets out a number of principles addressing: the relationship between fixed and variable remuneration; performance assessment and measurement; deferred payments; remuneration in instruments; early termination payments; pension payments; and anti-circumvention measures.

Disclosure

Under UCITS V, the prospectus, the key investor information document (the "KIID"), and the annual report must each provide information on the remuneration policy.

The prospectus must include either details of the remuneration policy itself, or a summary of that policy and a statement that the details of the actual policy may be found on a specified website and that a paper copy will be made available free of charge upon request. The KIID must include a statement to the same effect.

The UCITS' annual report must disclose the total remuneration paid by the management company and by the UCITS to identified staff, together with the number of beneficiaries and, where relevant, performance fees paid by the UCITS. The aggregate amount of remuneration must be broken down by category of employees or other staff members. The annual report must also describe how the remuneration and benefits have been calculated, detail the outcomes of the periodic reviews of the remuneration policy and its implementation and contain any material changes to the adopted remuneration policy.

Sanctions Regime

UCITS V aims to achieve minimum harmonisation of UCITS sanctioning regimes by setting out a non-exhaustive list of the types of breaches of the UCITS Directive which must give rise to penalties and the type of penalties which must be provided, including specifying the minimum level of administrative pecuniary sanctions for serious breaches of the UCITS Directive. Competent authorities and UCITS managers are required to establish whistleblowing mechanisms including protection for “whistleblowers”. Member states must facilitate whistleblowing through the establishment of effective and reliable mechanisms to encourage reporting of potential or actual breaches, including secure communication channels. Management companies, investment companies and depositaries must have in place a specific, independent and autonomous channel for their employees to report breaches internally. Employees of investment companies, management companies and depositaries who report breaches within those entities must be protected against retaliation, discrimination or other types of unfair treatment at a minimum.

Competent authorities must report each year to ESMA aggregated information on measures and sanctions imposed and inform ESMA of any individual measures and sanctions they have published.

UCITS V Implementing Measures

On 24 March 2016, implementing measures under UCITS V, providing further detail on the rules applicable to UCITS depositaries, were published in the Official Journal of the EU (the “**Level 2 Regulation**”). The Level 2 Regulation applies from 13 October 2016. The Regulation provides further detail in relation to the provisions to be included in the depositary contract, as well as the depositary’s initial and ongoing due diligence duties regarding the selection of a delegate and the rules for the segregation of assets.

Comment

All existing UCITS management companies and self-managed UCITS should at this stage have aligned their documentation and internal governance practices with UCITS V. If you require detailed advice relating to UCITS V, please get in touch with your usual Asset Management and Investment Funds Group contact or any of the contacts listed in this publication. Further briefing notes and updates on UCITS V may be accessed on our [website](#).

Full details of the Asset Management and Investment Funds Group, together with further updates, articles and briefing notes written by members of the Asset Management and Investment Funds team can be accessed at www.matheson.com.

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